

State of Montana  
Office of the Legislative Auditor

REPORT TO THE LEGISLATURE

BOARD OF INVESTMENTS

Financial-Compliance Audit

For the Fiscal Year Ended June 30, 1987

This report contains three recommendations related to the board's automated investment accounting systems. The recommendations address authorization of the system development arrangement, recording and tagging computer equipment to operate the system, and obtaining detailed users' manual for all automated systems. A fourth recommendation addresses accounting for bond swaps.

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## FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Office of the Legislative Auditor to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations which could have a significant financial impact. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office.

Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

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STATE OF MONTANA

# Office of the Legislative Auditor

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December 1987

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The Legislative Audit Committee  
of the Montana State Legislature:

This is our financial-compliance audit report on the Board of Investments for the fiscal year ending June 30, 1987. Included in this report are recommendations concerning authorization of the system development arrangement for the board's portfolio management system, recording and tagging computer hardware, obtaining users' manuals for all automated systems, and accounting for bond swaps. The board's responses are contained at the end of the report.

We thank the Executive Director and his staff for their assistance and cooperation.

Respectfully submitted,

A handwritten signature in cursive script, reading "Scott A. Seacat".

Scott A. Seacat  
Legislative Auditor



Office of the Legislative Auditor

BOARD OF INVESTMENTS

Financial-Compliance Audit  
For the Fiscal Year Ended June 30, 1987

Audit staff involved in this audit include: Jody Alke, Mary Bryson,  
Allyn Clark, Jim Manning, and Amy Vanica.

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STATE OF MONTANA  
BOARD OF INVESTMENTS  
APPOINTED AND ADMINISTRATIVE OFFICIALS  
JUNE 30, 1987

BOARD OF INVESTMENTS\*

<u>Member</u>	<u>Term Expires</u>
Joseph B. Reber, Chairman	January 1989
Robert L. Batista	January 1989
J. William Kearns	January 1989
Joel Long	January 1989
W.E. Schreiber	January 1991
Wilbur Scott	January 1991
Frederick B. Tossberg	January 1991

ADMINISTRATIVE OFFICIALS

David M. Lewis	Executive Director*
James R. Howeth	Investment Officer
James R. Penner	Assistant Investment Officer

- \* The 1987 legislature created a new nine member Board of Investments (BOI) as of July 1, 1987, by abolishing the Montana Economic Development Board and the former BOI and transferring to the new BOI the functions of the abolished boards. The law also created the executive director position.



## SUMMARY OF RECOMMENDATIONS

This listing serves as a means of summarizing the recommendations contained in the report and the audited agency's reply.

### Page

#### Recommendation #1

The Board of Investments:

- A. Authorize future system development projects prior to initiation of such projects. 4

Agency Response: Concur. See page 36.

- B. Document its understanding of the soft dollar arrangement in the board minutes. 4

Agency Response: Concur. See page 36.

#### Recommendation #2

The Board of Investments:

- A. Obtain documentation transferring ownership of the computer hardware. 5

Agency Response: Concur. See page 36.

- B. Record computer hardware on the state accounting system. 5

Agency Response: Concur. See page 36.

- C. Tag donated equipment as state property in accordance with state policy. 5

Agency Response: Concur. See page 36.

#### Recommendation #3

The Board of Investments obtain or develop a users' policy and procedures manual for its existing and planned automated accounting systems. 6

Agency Response: Concur. See page 37.

## SUMMARY OF RECOMMENDATIONS (continued)

Page

### Recommendation #4

The Board of Investments record bond swap transactions in accordance with generally accepted accounting principles and state accounting policy.

7

Agency Response: Do not Concur. See page 37.

## INTRODUCTION

We performed a financial-compliance audit of the Montana Board of Investments (board) investment activities for the fiscal year ended June 30, 1987. The board's operating expenditures are included in a separate audit of the Department of Administration for the two fiscal years ended June 30, 1987. Article VIII, section 13, of the Montana Constitution requires an annual audit of the board and this report represents compliance with the annual audit requirement. The objectives of the audit were to:

- 1) determine if the board's investment financial statements fairly present the financial position and results of operations for the fiscal year ended June 30, 1987;
- 2) determine if the board complied with applicable laws and regulations;
- 3) review the board's management and investment accounting control systems and make recommendations for improvements in the management and internal controls of the board; and
- 4) determine the implementation status of prior audit recommendations.

This report contains four recommendations to the board. These recommendations address areas where management, financial reporting, and compliance with laws and regulations can be improved. Other areas of concern deemed not to have a significant effect on operations of the Board of Investments are not specifically included in the report, but have been discussed with the executive director and his staff.

In accordance with section 5-13-307, MCA, we analyzed and disclosed the cost, if significant, of implementing the recommendations made in the report.

## BACKGROUND

The Montana Board of Investments was created by the Executive Reorganization Act of 1971 and has the primary authority to invest state funds. Chapter 581, Laws of 1987, created a new Board of Investments within the Department of Commerce by abolishing the Montana Economic Development Board and the former Board of Investments of the Department of Administration. The law transferred to the new Board of Investments the

functions of the abolished boards. As of July 1, 1987, the board consists of nine members appointed by the Governor.

The Board of Investments (board) employs an executive director, investment officer, and assistant investment officer, and they in turn hire and manage the other staff of the board. The staff advise the board, implement its decisions, and perform daily investment and record-keeping functions. Administrative charges to investing members fund the Board of Investments' operations. These fees are collected from income earned on monies invested.

The board directs the investment of state funds in accordance with the constitution and laws of the state. The board administers the investment program under the prudent expert principle which requires an investment manager to: discharge his duties with the care, skill, prudence, and diligence, under the circumstances prevailing, that a prudent person in a like capacity with the same resources and familiarity exercises; diversify the holdings of each participating fund to minimize the risk of loss and to maximize the rate of return; and discharge his duties solely in the interest of and benefit for the funds forming the unified investment program.

There are three major investment management programs within the board's operations. "All Other Funds" is a combination of approximately 50 separate investment funds. The investments are directly owned by the state agencies and managed on their behalf by the board. The investments, generally long-term in nature, are managed to produce steady yields over a long period of time.

The "Short-Term Investment Pool" (STIP) provides a short-term investment vehicle to state or local government investors. Formerly there were two short-term investment pools: STIP for state agency investors, and STIP II for local government investors. On January 30, 1987, STIP participants sold their STIP units and purchased STIP II units. This conversion resulted in a single fixed unit value short-term investment pool called STIP. The purpose of STIP is to provide the highest possible return, yet maintain a highly liquid position. The short-term investment portfolio is managed by the board, and participants may purchase or sell units on a daily basis.

The "Montana Common Stock Pool" (Mont-Comp) is an investment pool designed to allow authorized agencies to participate in the equity market via a diversified pool. The Montana Constitution authorizes only the retirement

funds to invest in private corporate capital stock. The board manages the securities in the portfolio, and participants purchase units on a monthly basis.

#### AUTOMATED INVESTMENT ACCOUNTING SYSTEM

In 1983, the board entered into a \$305,000 contract with a private computer services company to develop an investment accounting and portfolio management system for all three investment programs. The contract called for a completion date between September 1984 and February 1985, and required the computer services company to obtain a performance bond for the full amount of the contract. In October 1985, the board retained the services of a local computer consulting firm to examine the system and develop procedures for testing it. Our fiscal year 1985 audit report contained recommendations related to the board's procedures and contract arrangement concerning this software development project. In our fiscal year 1986 audit report we noted that the system was not yet operational because of delays and pending resolution with the private company we made no recommendation. Issues similar to those presented in the fiscal year 1985 report are again discussed in this report.

#### Authorization and Documentation

During fiscal year 1987, the board determined that the automated investment accounting system would not be operational. In February and in April 1987, the board's attorney informed the performance bond holder that the board desired to call the bond due to lack of performance on the contract. As of October 6, 1987, this issue had not been resolved and the board considered legal action. Subsequently, the bond holder posted the bond, and in December 1987 the board settled with the computer firm for \$127,500.

In January 1986, pending resolution of the dispute with the computer firm and the bond holder, board personnel entered into an arrangement whereby the local computer consulting firm proceeded with development of automated investment accounting systems at a total proposed cost of \$240,000. A local broker used by the board for investment transactions agreed to pay the computer firm. This practice, referred to as a "soft dollar" arrangement, is common in the investment industry and is authorized by 17 CFR, Part 241,

Section 28(e), Securities and Exchange Commission (SEC). This section permits money managers to use commission dollars to obtain investment research and brokerage services. The board's attorney issued a legal opinion in March 1987 stating that although the board is not subject to SEC regulations, the soft dollar arrangement was in compliance with applicable state and federal laws. Such an arrangement was subsequently authorized by House Bill 2, Session Laws of 1987:

The board of investments may utilize designated commissions paid on the purchase and sale of securities for products and services customarily provided by brokers for such transactions according to applicable securities industries rules and regulations and Montana statutes.

The legislative authorization was effective July 1, 1987.

We found no documentation to indicate the board was formally notified of this arrangement until the February 1987 board meeting. By that time the board had received \$180,439 of services and equipment from the local firm. The automated system under development at the board has been acquired solely through commission dollars. The board did not use its own funds and therefore did not obtain expenditure authority from the legislature.

There is no formal written agreement between the board and the local computer consulting firm. SEC regulations state that a fiduciary customer (the board) cannot mandate the soft dollar services to be received from a broker, thereby precluding a written contract for those services. To protect the interests of the board, and to clarify such issues as ownership of the software/hardware at the completion of system development and potential services to be provided, the board should document their understanding and approval of such transactions in the board minutes.

#### RECOMMENDATION #1

##### WE RECOMMEND THE BOARD OF INVESTMENTS:

- A. AUTHORIZE FUTURE SYSTEM DEVELOPMENT PROJECTS PRIOR TO INITIATION OF SUCH PROJECTS.
- B. DOCUMENT ITS UNDERSTANDING OF THE SOFT DOLLAR ARRANGEMENT IN THE BOARD MINUTES.





















































































































